Heritage

Quarterly Newsletter & Investment Review

Issue 75 Quarterly news & investment review from Heritage Quarter 3 2016

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Heritage Capital Management Limited

Heritage Capital Management Limited is an independent, specialist investment management company based in London and regulated by the Financial Conduct Authority, providing a wide range of investment services to individuals, trusts, companies and pension funds.

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Post Brexit bounce

After a sharp initial plunge following the shock EU referendum results, markets quickly stabilised and then rallied strongly over the third quarter.

We are pleased to report that the Heritage Managed Portfolio Fund has benefitted from this post Brexit bounce, producing a return of 6.4%, its best quarterly performance since 2009. Full details of our Funds including the current asset allocation and a commentary on performance can be found as usual on page 3.

Why the UK is still a good home for global investors

Although the recent turmoil surrounding the UK's historic vote to leave the European Union has highlighted that significant political risk can emerge in even one of the most stable and established of democracies, ongoing events elsewhere around the world have served to put things back into context and it is worth recalling why the UK remains a good place for global investors.

Europe has yet to solve its major problems which include a refugee crisis and the tensions between its relatively stronger core and the weaker peripheral members of the Eurozone, which could yet result in it being ripped apart. Political risk in the US is currently heightened with the race to be president now down to a choice between two deeply divisive candidates and general unrest and political turmoil continues to be the norm in much of the developing world. Meanwhile, whilst the long-term implications of Brexit remain unclear, at least things have been quickly stabilised under the leadership of the UK's new Prime Minister, Theresa May.

Furthermore, London remains the major global financial hub and the reasons for this are deep rooted and likely to endure, being partly historical (as an open, developed market with a multitude of global relationships, good corporate governance and a strong legal and regulatory framework), and partly geographical (sitting in the European time zone, whilst straddling the US and the fast growing markets of the far east). It also helps that English is the main international business language and that the UK now has one of the lowest corporation tax rates in the developed world.

London is therefore not just a home for domestic UK companies, but is seen as a good base for a wide range of global multinational groups and an analysis of the total turnover of all UK listed companies reveals the broad split is roughly one third each in the UK, Europe/US and emerging markets/other. It is also interesting to note that the UK's largest listed company, HSBC, having considered moving its base to the Far East where it earns the largest part of its profits, earlier this year committed to retaining its headquarters in the UK, despite all the noise surrounding Brexit.

Overall, the establishment of London as an attractive domicile for global businesses and many specialist listed funds has resulted in the UK stock market providing perhaps the best range of investment options for international investors, which is why it continues to play a major role in our investment activities here at Heritage.

Market Commentary and Outlook

Following a fairly tumultuous first half of the year, investors enjoyed a much smoother ride in the third quarter as markets progressed upwards over the summer months and the TR Global Index gained 5.80%.

Although rising equity markets generally tend to give investors a comfortable feeling, there is a concern that the current rally for the major indices is not being supported by earnings growth from the underlying companies, which is leading to many shares becoming rather expensive based on their P/E (price to earnings) ratios.

The table below shows that PE ratios for the major markets have risen to around 20, which is above the long-term average and is made harder to justify given the current anaemic earnings growth. Furthermore, the measure for earnings tends to exclude "exceptional" costs and whilst this may make sense when analysing trends in profitability for a particular company it can paint a misleadingly positive picture when applied to the entire market, as history suggests that these so called "exceptional" items have a nasty tendency to be recurring rather than one-off in nature.

Of course despite these valuation concerns it is still possible to make a bullish case for equities as an alternative to bonds, which are themselves currently on historically low yields, but if share prices continue to rise sensible investors will also be keeping a nervous eye on corporate earnings growth and PE ratios.

United Kingdom

The UK was the best performing major market this quarter with the FTSE 100 index gaining 6.1% and it is also now the only major market with a year-to-date return of over 10%.

Whilst it was initially the global multi-nationals in the FTSE 100 index, boosted by the weaker pound, that led the post Brexit rally, smaller companies subsequently joined the recovery and overall for the third quarter the FTSE 250 mid cap index and the FTSE Smaller Companies index both gained around 10%, outperforming the large caps.

Although there remains a considerable amount of uncertainty surrounding the long-term implications of Britain leaving the EU, the initial fears of an immediate recession induced by a crisis of confidence has been averted as the surprisingly swift and smooth transition to a new cabinet headed by Theresa May has restored order and the Bank of England also moved quickly to cut interest rates from their already low 0.5% to just 0.25%.

United States

With a gain of 3.3% for the S&P 500 index the US was actually the weakest of the major markets this quarter, although as ever there was a divergence within this broad average with the technology heavy Nasdaq index gaining around 10%, whilst the more industrial Dow Jones index was marginally down.

Not surprisingly the upcoming US Presidential Election campaign continues to dominate the news. It appears that American voters will not exactly be spoiled for choice on November 8th and the other big decision that will be of interest to investors will be whether and to what extent the Federal Reserve raises interest rates in December.

Europe

European markets had a decent quarter with the index gaining 4.8% but remains down by over 8.1% for the year-to-date. The banking system continues to be a major weakness within Europe with a number of Italian banks continually teetering on the brink and more recently the once mighty Deutsche Bank in Germany has been put under severe pressure due a massive $14bn fine imposed by the US Justice Department.

Japan

Although the Japanese market had a much better quarter with the Nikkei gaining 5.6%, boosted by the central bank reducing the official interest rate to -0.1% and a near doubling of the share price of Nintendo thanks to the wildly successful Pokemon Go launch, it is still down by over 13.5% for the year-to-date and it remains to be seen if the battle to boost bank lending and generate inflation will be successful.

Emerging Markets

Emerging markets have continued to enjoy a better year relative to developed markets with Brazil's Bovespa index leading the way with a gain of around 14% in the third quarter, helping to boost its year-to-date rise to an impressive 37%.

Investment Statistics - 30/09/2016

Equity Markets	Q3 2016	2016	2015	PE Ratio	Dividend Yield	Central Bank Interest Rates	10 yr Gvnmt Bond Yields	Exchange Rates vs GBP	Exchange Rates vs USD
TR Global ($)	5.80%	7.14%	-2.07%						
US (S&P 500)	3.31%	6.08%	-0.73%	20	2.5%	0.50%	1.61%	1.2977	1.0000
UK (FTSE 100)	6.07%	10.53%	-4.93%	22	3.9%	0.25%	0.76%	1.0000	1.2977
Europe (STOXX 50)	4.80%	-8.12%	3.85%	17	4.0%	0.00%	-0.12%	1.1543	1.1238
Japan (Nikkei 225)	5.61%	-13.58%	9.07%	18	2.0%	-0.10%	-0.08%	131.43	101.33

Total returns- including dividends

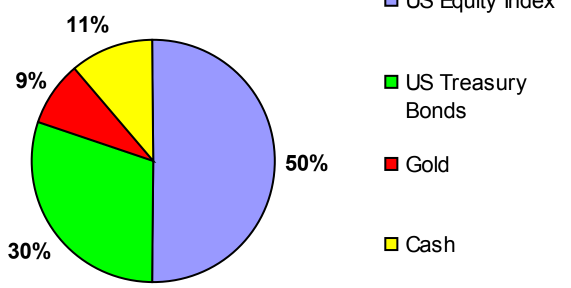
Source: Thomson Reuters and the Financial Times

Heritage Investment Fund Limited

Review for the quarter ended 30th September 2016

Performance	Absolute Return Funds		Managed Portfolio Fund	Inflation (UK)	TR Global World Index (£ total return)
Risk profile	Low		Medium		
Minimum investment horizon	3 years +		5 years +		
Target net annual return	Inflation plus 2-3% (ie 3-4%)		6-7%		
Price at 30 September 2016	£173.92	US$142.82	£261.99		
Return for quarter (net)	1.77%	1.77%	6.40%	0.14%	8.52%
Year 2016 return to date (net)	1.05%	1.34%	5.55%	0.30%	21.69%
Year 2015 return (net)	-0.23%	-0.47%	6.80%	0.06%	3.49%
Year 2014 return (net)	6.20%	5.42%	7.74%	1.67%	10.99%
Year 2013 return (net)	4.67%	3.98%	13.85%	2.61%	19.85%
Year 2012 return (net)	1.28%	1.95%	13.27%	2.87%	7.93%
Year 2011 return (net)	-2.22%	-2.28%	0.06%	4.55%	-4.50%
Compound annual return (from 1/01)	3.72%	2.22%	6.35%	2.11%	5.93%
Annual volatility	6.18%	6.20%	5.25%	0.07%	10.19%
Size of Fund (millions)	£10.4	U$10.0	£150.1		

Absolute Return Funds



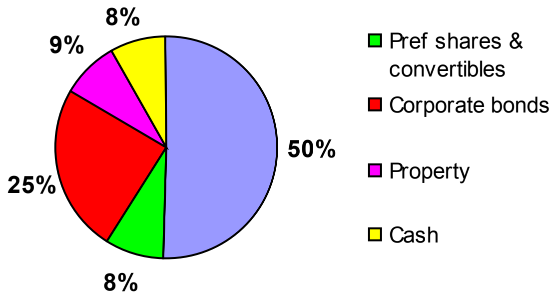
The Absolute Return Funds aim to protect investors capital and generate annual returns in excess of inflation by investing in liquid exchange traded funds which track developed equity and bond market indices, with the risk of significant losses being hedged using derivatives.

The net exposure to the core equity index funds, which track the S&P 500 largest US companies, was 50% at the end of the quarter. These exchange traded funds gained 2.32% for the quarter as the US equity market recovered on the expectation that the pace of future interest rates increases will be slower. The gains in the US equity market index during the quarter came from strong performance from the technology, financial and industrial sectors, whilst the utilities, consumer staples and real estate sectors recorded losses for the period on the expectation that interest rates will be increased in December of this year.

The exposure to the US equity market is hedged against significant losses by the purchase of protective put options. The Funds are further hedged by exposure to US Treasury bond and gold futures, which have a negative or low correlation to equity market returns. These derivatives positions lost a net 0.23% for the quarter.

The Funds produced a steady return for the quarter, and are well positioned to generate returns in excess of inflation in the medium term, with limited downside risk.

Managed Portfolio Fund



The Managed Portfolio Fund seeks to generate long-term capital growth at a lower risk than that associated with pure equity market investment through active management of a well diversified multi-asset portfolio.

The Fund had its best quarter since 2009, gaining 6.4% as it benefitted from a post Brexit rally, and for the year-to-date the return is now just over 5.5%.

There were positive contributions virtually across the board from our equity holdings this quarter, with the top performers that gained over 20% including a mixture of sectors as well as both large and small companies. We also received a boost from a takeover offer for our holding in UK Mail at the end of September.

Our bond portfolio also had a good quarter with investment grade bonds benefitting from falling interest rate expectations and our higher yield bonds helped by a tightening of spreads on riskier assets. Our property holdings have also recovered well following the initial sharp post Brexit plunge.

Overall, we continue to believe that our portfolio of investments remains well positioned to generate attractive returns for long-term investors, whilst our relatively defensive positioning and diversification should continue to provide some protection against any major market setbacks.

Winding down the Heritage Sterling Absolute Return Fund

Those clients invested in our low risk Absolute Return Funds will appreciate that the core of these Funds is invested in liquid US equity index exchange traded funds. The purpose of these funds is to give investors exposure to many of the largest global companies that make up the S&P 500 index, including the increasingly important areas of information technology and healthcare. In addition, the Fund may invest in bond and gold exchange traded funds or futures in order to reduce the downside risk as these securities have a negative or low correlation with equities. The risk of making substantial losses on the equity exposure is hedged using options, but the costs associated with this does reduce the overall return.

Some of our Sterling based clients have a portion of their funds invested with us in the US Dollar version of our Absolute Return Fund as a currency and market hedge against having everything invested in Sterling in the UK financial markets. This is particularly relevant given the uncertainty surrounding the outcome of the UK's decision to leave the EU. These Sterling clients have benefitted significantly from the strength of the US Dollar as the world's reserve currency in times of market weakness during the credit crisis of 2008 and more recently over the last few years.

However, those clients invested in the Sterling Absolute Return Fund have not benefitted from any such currency diversification as all the US Dollar exposure of this Fund is hedged back into Sterling. We have, therefore, decided that clients currently invested in the Sterling Absolute Return Fund, and who wish to remain invested in Sterling, would be better off if they switched into our Sterling denominated Managed Portfolio Fund, which has an excellent long term performance record with low volatility and holds a well diversified multi-asset spread including equities, bonds and property.

At the end of this month we will, therefore, be automatically switching all clients invested in our Sterling Absolute Return Fund into our Sterling Managed Portfolio Fund, with the exception of a number of clients who specifically wish to diversify their currency and market exposure by moving into the US Dollar version of our Absolute Return Fund.

Specialist listed investment funds

On page one of this newsletter we referred to the fact that in addition to the number of global businesses that choose the UK as their base there is also a thriving market for specialist investment funds that are listed on the London Stock Exchange.

This is a particularly useful market for a fund such as our Heritage Managed Portfolio Fund, as whilst we generally prefer to invest directly in shares and bonds, specialist listed funds can provide further opportunities as well as an extra level of diversification. Also, although analysing investment trusts and companies is not that simple, due to the fact that these funds often do not trade in line with their underlying net asset values, it can be very rewarding for those who take the time to develop a good understanding.

A very good example of this is our investment in the listed private equity investment trust, Electra. Closed end funds are particularly well suited for gaining exposure to illiquid assets such as private equity as there is no pressure for the managers to buy or sell in response to new subscriptions and redemptions that can create such problems for open ended funds. Our Managed Portfolio Fund first bought shares in Electra at under £16 in 2012 when they were trading at a 30% discount to their net asset value at the time of around £22. Since then the performance has been excellent with the NAV doubling to £44 today. Furthermore due to this good performance and the attentions of a large activist investor the discount has significantly narrowed providing an overall gain of well over 150% for our original investment.

Model risk-adjusted asset allocations for Heritage's mutual funds:

	Suggested Asset Allocation		Target returns	Last 12 months Actual return	Compound annual return since 1/1/01	Average volatility
	Absolute Return Fund	Managed Portfolio Fund				
Model Portfolios:			£	£	£	
Cautious	75%	25%	5.5%	5.5%	4.4%	5.6%
Balanced	50%	50%	6.0%	6.7%	5.0%	5.3%
Growth	0%	100%	7.0%	8.9%	6.4%	5.3%
Benchmarks:						
UK Inflation				0.3%	2.3%	0.1%
TR Global Equity Index (total return)				30.9%	6.3%	10.2%

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